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Supreme Court, U.S.  
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In The  
**Supreme Court of the United States**

— ♦ —  
HUNT-WESSON, INC.,

*Petitioner,*

v.

FRANCHISE TAX BOARD,

*Respondent.*

— ♦ —  
**On Writ Of Certiorari To The  
Court Of Appeal Of California  
For The First Appellate District**

— ♦ —  
**BRIEF FOR RESPONDENT**

— ♦ —  
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## QUESTION PRESENTED

California permits a corporation engaged in business in the State to deduct from its taxable income all interest paid or accrued within a taxable year on indebtedness incurred in the production of that income. For a corporation engaged in business both in and out of California, the amount of the interest deduction taken into account by California is statutorily determined. Cal. Rev. & Tax. Code § 24344. This statute is designed to close a judicially acknowledged tax loophole by preventing a corporation from obtaining a double tax benefit by investing its own business capital in nonbusiness activities which generate dividends and interest income exempt from California taxes, while simultaneously operating its business on borrowed funds, thereby generating an interest expense deduction for itself. California attempts to curtail this practice by prescribing an ordering rule for matching a corporation's interest expense with the category of income, including dividend and interest income from investments, to which the indebtedness is attributable. Against this background, the following question is presented:

Whether California's statutory method of allocating a corporation's interest expense to business and nonbusiness income for the purpose of calculating its apportionable business income subject to California tax is constitutionally permissible.

## LIST OF PARTIES

Petitioner is Hunt-Wesson, Inc. ("Hunt-Wesson"). In proceedings before the California courts, petitioner has been referred to as Hunt-Wesson, Inc., Successor in Interest to Beatrice Companies, Inc., and as Hunt-Wesson, a Successor by Merger with Beatrice Company, formerly known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

Respondent is the Franchise Tax Board for the State of California ("Board").

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## OPINIONS BELOW

The Opinion of the California Court of Appeal is found in the Joint Appendix ("J.A.") at 54-66. The proposed statement of decision of the California Superior Court, City and County of San Francisco, is located at J.A. 33-53. The California Supreme Court's denial of Hunt-Wesson's petition for review is found at J.A. 67. None of the above-referenced opinions was officially reported.

## STATEMENT OF JURISDICTION

The California Court of Appeal entered judgment in favor of the Board on December 11, 1998. J.A. 54-66. The California Supreme Court denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67. Hunt-Wesson's petition for certiorari was filed on June 22, 1999, and was granted on September 28, 1999. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).

## CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Due Process Clause of the Fourteenth Amendment of the United States Constitution, U.S. Const., amend. XIV, § 1, provides that "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides that "Congress shall have Power . . . [t]o regulate Commerce . . . among the several States."

During fiscal years 1980 through 1982, the relevant years at issue, California Revenue and Taxation Code section 24344 provided as follows:

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid

or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula.<sup>1</sup>

### STATEMENT OF THE CASE

This is an action for refund of California franchise taxes collected from Hunt-Wesson, a corporation engaged in business throughout the world, including California, during fiscal years ended 1980 through 1982 ("years in issue"). Hunt-Wesson seeks a refund of \$1,523,462 and applicable interest thereon.

#### A. California's method of taxing multistate corporations

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. When a corporation derives its income

<sup>1</sup> Statutory differences between the current version of section 24344 and the version in effect during the years in issue here are not relevant. The words "allocation by formula" are interpreted to mean "apportionment by formula," the statutory term currently used.

from sources both in and out of California, its tax is measured by net income derived from or attributable to sources within California. Cal. Rev. & Tax. Code § 25101. The amount of a corporation's net income derived from or attributable to sources within California is determined pursuant to the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). Cal. Rev. & Tax. Code § 25120 *et seq.* Under the UDITPA provisions, multi-state corporations are potentially subject to tax from two streams of income: (1) business income, and (2) nonbusiness income attributable to taxable activities within the State.<sup>2</sup> A multistate corporation's total income equals the sum of these two streams of income.

When a multistate corporation is engaged in a unitary business, its worldwide business income is apportioned among the various states by use of an apportionment formula.<sup>3</sup> Cal. Rev. & Tax. Code §§ 25121 & 25128. California has adopted a standard apportionment formula under which income is apportioned to the State by reference to the total aggregate business income of the entire group of corporations which comprise the unitary business. Net business income is derived by deducting allocable expenses from total business income.

<sup>2</sup> Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income is defined as all income other than business income. Cal. Rev. & Tax. Code § 25120(d).

<sup>3</sup> This Court has described a unitary business as a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 178-179 (1983).



Nonbusiness income and expenses are not subject to apportionment, but instead are allocated entirely to a single state.<sup>4</sup> Cal. Rev. & Tax. Code §§ 25123-25127. Nonbusiness income in the form of dividends and interest is generally allocable to the state where the taxpayer is commercially domiciled.<sup>5</sup> See Cal. Rev. & Tax. Code §§ 25123 & 25126.

**B. California Revenue and Taxation Code section 24344(b)**

Section 24344(b) of the California Revenue and Taxation Code allows for California franchise tax purposes a deduction for "interest paid or accrued on indebtedness" incurred by a corporation whose income is derived from sources both in and out of the State. The corporation's tax is measured by net income derived from or attributable to sources within California. Cal. Rev. & Tax. Code § 25101. By its terms, section 24344(b) applies only to a corporation doing business both in and out of California and whose California business income is determined by the application of apportionment principles. Section 24344(b) also provides a formula, known as the "interest offset" provision, for calculating the amount of interest expense which a corporation may deduct against its business income in California.

Contrary to Hunt-Wesson's erroneous allegation that section 24344(b) is applied only to what it mischaracterizes as "business interest expense" (Petitioner's Brief

<sup>4</sup> This Court has held that California's statutory treatment of business and nonbusiness income satisfies due process requirements. *Container Corp.*, 463 U.S. at 167, 180-84.

<sup>5</sup> Certain types of nonbusiness income, such as capital gains on sales of real property, are allocated not on the basis of domicile, but situs. See Cal. Rev. & Tax. Code §§ 25123-25127.

("Pet. Br.") at 25), the statute is applied to all "interest" expense paid or accrued on indebtedness as follows:

*First*, interest expense incurred on indebtedness by a corporation is attributed to its business income (*i.e.*, income subject to apportionment by formula) to the extent that the corporation has earned interest income from its business operations. This amount of interest expense is fully deductible against the corporation's business income that is apportioned to California.

*Second*, the balance, if any, of the corporation's interest expense is attributed to, or offset by, any nonbusiness interest and dividend income (*i.e.*, income not subject to the apportionment formula) from investment activities.<sup>6</sup>

*Third*, any remaining interest expense in excess of the corporation's nonbusiness interest and dividend income is fully deductible against apportionable business income.<sup>7</sup>

A simplified example illustrates the manner in which the "interest offset" provision of California's statute is applied. Assume in a taxable year that a corporation is engaged in a unitary business in and out of California and has \$1,000 of interest expense from debt, \$250 of

<sup>6</sup> Dividends which are deductible pursuant to Cal. Rev. & Tax. Code § 24402 are excluded from the statutory formula. Section 24402 provides for a deduction to the recipient of dividends declared from income which has been "included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends."

<sup>7</sup> Generally, the residual interest expense is deductible against the corporation's apportionable business income. In certain cases not pertinent here, the remaining interest expense may also be available as a deduction against the corporation's nonbusiness income (exclusive of nonbusiness interest and dividend income already offset under the interest offset statute). See Cal. Code of Regs. tit. 18 § 25120(d).

interest income from business operations and \$300 of investment income from nonbusiness stocks and bonds. Under the statute, the \$1,000 of interest expense is first attributed to and deductible against the corporation's total unitary business income to the extent of the corporation's business interest income, *i.e.*, \$250. Second, of the remaining \$750 (\$1,000 less \$250) of interest expense, \$300 is attributed to and offset by the corporation's \$300 of nonbusiness income. (By this process, the remaining \$750 of interest expense available as a potential deduction against the corporation's apportionable business income is reduced by \$300.) Finally, the \$450 (\$750 less \$300) balance of interest expense is deductible against the corporation's unitary business income. Thus, a total of \$700 (\$250 plus \$450) of the \$1,000 interest expense is deductible against the corporation's total unitary business income apportionable to California. The remaining \$300 is allocated to the corporation's nonbusiness income, which is taxable in its state of domicile.

### C. California's interest offset statute as applied to Hunt-Wesson

Hunt-Wesson is a corporation incorporated in Delaware and domiciled in Illinois. J.A. 18 (Stip. ¶ 1).<sup>8</sup> A diversified food company producing a wide range of food and food-related products and services for worldwide markets, Hunt-Wesson is engaged in business both in California and throughout the world. J.A. 18 (Stip. ¶ 2).

During the three years in issue, Hunt-Wesson earned income in the form of interest from its unitary business operations in the amounts of approximately \$10 million,

<sup>8</sup> References to the Joint Stipulation of Facts in this case are denominated "Stip." followed by a paragraph reference.

\$21 million and \$84 million respectively. Clerk's Transcript ("CT") 8, 120.

Hunt-Wesson owned a number of dividend-paying subsidiaries, none of which was a member of Hunt-Wesson's unitary business group of corporations. J.A. 19 (Stip. ¶ 7). These subsidiaries paid dividends to Hunt-Wesson during the three years in issue in an amount approximating \$27 million, \$29 million and \$19 million respectively. J.A. 19 (Stip. ¶ 7). Hunt-Wesson treated all of these dividends as nonbusiness income not subject to tax by California. J.A. 19 (Stip. ¶ 8).

Hunt-Wesson also incurred interest expense from loans during the three years in issue in the approximate amounts of \$80 million, \$55 million and \$137 million respectively. J.A. 19-20 (Stip. ¶ 10). None of the interest expense incurred was reported by Hunt-Wesson as assignable to the approximately \$75 million of total nonbusiness dividend income which Hunt-Wesson received during the years in issue. Rather, Hunt-Wesson claimed that the entire amount of the approximately \$273 million of interest expense incurred during the years in issue was attributed to, and fully deductible against, its business income subject to California franchise tax. J.A. 20 (Stip. ¶ 10).

Following an audit of the years in issue, and by operation of California's interest offset provision, the Board authorized Hunt-Wesson to deduct nearly \$198 million of the approximately \$273 million of interest expense against its business income apportionable to California. See Appendix to Brief for Respondent ("App.") at 1a *infra*. The Board computed Hunt-Wesson's interest expense deduction adding the amount of interest expense equal to its business interest income and the amount by



which the remaining interest expense exceeded its non-business dividend income.<sup>9</sup> The balance of the interest expense was attributed to and offset by the amount of Hunt-Wesson's nonbusiness dividend income. J.A. 19-20 (Stip. ¶¶ 7, 10-12). Because the nonbusiness dividends were not subject to taxation in California pursuant to the UDITPA provisions, the interest expense attributed to those dividends did not reduce the amount of Hunt-Wesson's California business income.

As a result of the amount of interest expense deductions claimed by Hunt-Wesson, the Board assessed a tax deficiency against Hunt-Wesson for each of the three years in issue. J.A. 21 (Stip. ¶ 16). Hunt-Wesson paid the deficiencies and filed an administrative claim for refund with the Board. J.A. 22 (Stip. ¶¶ 18 & 21). The claim for refund was denied. J.A. 23 (Stip. ¶ 22).

#### D. The California Superior Court decision

Hunt-Wesson filed a suit for tax refund in the California Superior Court. In its complaint, Hunt-Wesson challenged the constitutionality of California Revenue and Taxation Code section 24344(b) on the grounds that it violated the Due Process Clause, Commerce Clause and Equal Protection Clause of the Constitution.

Following a trial, the superior court entered judgment in favor of Hunt-Wesson on several grounds.

First, although acknowledging that this Court has historically taken a "symmetrical view" of taxation in which income and expenses are paired so that a taxpayer should not be permitted to deduct expenses related to generating income exempt from taxation, the superior

<sup>9</sup> Although the California statute refers to "interest and dividend income . . . not subject to allocation by formula," all of the nonbusiness income at issue here is dividend income.

court found that California's statute violated due process because it attributed interest expense to non-taxable dividend income without regard to whether such interest was related to the dividend income. J.A. 43-46.

Second, by virtue of the fact that Hunt-Wesson's nonbusiness dividend income was taxable only by Illinois, the state of its domicile, the superior court declared that the statute operated impermissibly to tax a foreign corporation more than a similarly situated domestic corporation, thus interfering with interstate commerce. J.A. 46-48.

Finally, the superior court stated that its finding that the statute applied unequally to domestic and foreign corporations compelled the conclusion that the statute violated equal protection. J.A. 49-51. The Board appealed.

#### E. The California Court of Appeal decision

Relying in large part on the California Supreme Court's decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal.3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), the California Court of Appeal ruled that section 24344(b) was constitutional and reversed the judgment of the superior court. J.A. 54-66.

The court of appeal first acknowledged that the "theory of the interest offset rule [of section 24344(b)] is that a corporation should not be able to borrow money to purchase stocks that pay dividends and then get a deduction for the interest while the dividend income (being investment or nonbusiness income) is not taxable. [Citation.]" J.A. 58. Consistent with this theory, the court of appeal observed that the California Supreme Court in *Pacific Telephone* had ruled that the California Legislature had acted reasonably in treating interest expense as the opposite of dividend income and by requiring the offset of one against the other. J.A. 58. The court of appeal

noted that the California Supreme Court in *Pacific Telephone* clearly was aware that the dividend income of a foreign corporation is not taxable in California. J.A. 61. However, the California Supreme Court determined that such income nevertheless fell within the language and logic of the statute, which was designed to offset interest expense against investment income. J.A. 59. Quoting from *Pacific Telephone*, the court of appeal declared that a finding in favor of Hunt-Wesson would result in the creation of a tax loophole whereby a foreign corporation would be able to "borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money." J.A. 59.

The court of appeal rejected Hunt-Wesson's contention that the statute operated to tax indirectly income not subject to California taxation. J.A. 61. In so ruling, the court of appeal relied on the California Supreme Court's finding in *Pacific Telephone* that the inclusion of non-taxable dividends in the statutory computation did not constitute taxation of the dividends themselves, which were reasonably applied to offset the interest expense deduction. J.A. 59. Quoting again from *Pacific Telephone*, the court of appeal declared that "California has a substantial interest in making sure that income attributable to this state is not distorted by use of the interest expense deduction, and under subsection (b), the dividends received are only taken into account to offset the interest expense deduction." J.A. 59.

Hunt-Wesson's claim that the California statute facially discriminated against interstate commerce was also rejected. J.A. 62-65. The court of appeal ruled that this contention collided with the holding in *Pacific Telephone* that the statute does not operate to impose a tax on non-taxable investment income. J.A. 62. The court of

appeal also distinguished several of this Court's decisions dealing with facially discriminatory statutes, including *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), in which this Court invalidated North Carolina's intangibles tax. J.A. 62-63. Unlike *Fulton*, the deductibility of interest expense under the California statute was determined not by Hunt-Wesson's domicile, but rather by the character of the income attributable to that expense. J.A. 62-63. Any favoritism shown to domestic corporations was indirect and incidental. J.A. 62. Moreover, California's statute was part of an overall apportionment scheme which did not distinguish between domestic and foreign corporations and the "same rules and logic of offsetting interest expense against investment income are applied to both." J.A. 62.

The court of appeal furthermore rejected Hunt-Wesson's claim that the California statute discriminates by parenthetically omitting from the interest offset computation dividends declared from income already taxed to the dividend payor by California. J.A. 64; see n. 6, *supra*. Since the State had already taxed the dividends in question, no unconstitutional discrimination resulted from California's efforts to refrain from double taxation. J.A. 64. In contrast to *Fulton*, the California statute did not waive an otherwise uniform intangibles tax based entirely on the percentage of the underlying corporate income taxed by the State. Rather, the statute operated as "part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable." J.A. 64.

Finally, Hunt-Wesson's equal protection claim was rejected. The court of appeal determined that the California statute did not create an arbitrary classification based



on domicile, but rather was rationally related to California's need to close a "gaping tax loophole." J.A. 65.<sup>10</sup>

#### F. The California Supreme Court decision

Hunt-Wesson sought review of the California Court of Appeal's decision. The California Supreme Court denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67.

#### SUMMARY OF ARGUMENT

California permits a corporation subject to tax in the State to deduct from its taxable income all interest paid or accrued within a taxable year on indebtedness incurred in the production of that income. However, like many states, California does not allow a deduction of interest expense that is attributable to the production of income which the State is barred from taxing. Because money is fungible and cannot be readily traced to its ultimate application, California applies a formula by which interest expense incurred by a corporation doing business both in and out of the State is statutorily allocated to classes of income. California's statute fairly and rationally allocates a corporation's interest expense to its taxable and non-taxable income by the measure of specific kinds of income realized by the corporation from both business activities and nonbusiness (or investment) activities. This statute is intended to plug a destructive tax loophole by which a corporation may obtain a double tax benefit by investing its own business capital in nonbusiness activities which generate income exempt from California taxes, while simultaneously operating its business on borrowed

<sup>10</sup> Hunt-Wesson has not pursued its equal protection claim in this Court. Pet. Br. at 12 n. 13.

funds, thereby generating an interest expense deduction for itself.

Hunt-Wesson concedes that "interest expense should be allocated to the income it helps produce." Pet. Br. at 23. Furthermore, it claims to have no quarrel with a formula which fairly assigns interest expense to related income. *See* Pet. Br. at 25-32. Hunt-Wesson nevertheless insists that not one dollar of the indebtedness which generated more than \$273 million of interest expense during the years in issue was attributable, either directly or indirectly, to the production of approximately \$75 million of non-taxable dividends by its nonunitary subsidiaries. In attempting to justify this position, Hunt-Wesson attacks California's particular statutory method of matching interest expense to classes of income as irrational and resulting in the indirect taxation of non-taxable income.

Hunt-Wesson seeks to support its contentions by misstating the manner in which California's statute is applied. Hunt-Wesson also seeks in essence to have this Court "constitutionalize" a particular method for allocating interest expense by pointing to various "fair" interest allocation formulas utilized by other jurisdictions. However, Hunt-Wesson is silent as to how any of these other formulas is more "fair" than California's statute and makes no showing that it would be entitled in fact to a greater tax deduction under any of these methods than under California's statute. By embracing these alternative formulas which, similar to California's statute, assign interest expense to taxable income by reference to non-taxable investment activities, Hunt-Wesson indirectly acknowledges the rational relationship between interest expense and non-taxable income stemming from the fungible nature of money which is the foundation of California's statute.

What Hunt-Wesson attempts to characterize as a violation of California's jurisdiction to tax is in fact a complaint about California's long-standing formula for allocating deductible interest expense to business-related income, which the State indisputably is empowered to tax. California's statute does not impose a tax on a corporation's non-taxable investment income, either directly or indirectly. Rather, the statute allocates interest expense from indebtedness to business income and nonbusiness income in a manner which reflects economic reality. By so doing, California seeks to ensure that a corporation engaged in business in the State pays its fair share of taxes.

Hunt-Wesson also challenges California's statute on the ground that it discriminates against interstate commerce by favoring domestic corporations over foreign corporations. In fact, the statute is applied identically to domestic and foreign corporations alike – interest expense is allocated to business and nonbusiness income in the same manner and to the same extent regardless of where the corporation is domiciled – and is neutral on its face. The statute aims to ensure that a corporation that invests in non-taxable activities while simultaneously operating on borrowed funds and a corporation that operates on its own capital without such investments are similarly situated for State tax purposes. The statute furthermore meets the constitutional test of "internal consistency" – if every jurisdiction in which Hunt-Wesson was taxable utilized a statute identical to California's, Hunt-Wesson would realize the full benefit of each dollar of interest expense which it incurred against its worldwide income. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983); *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644-45 (1984).

Hunt-Wesson seeks to live in a world where a corporation may freely manipulate the amount of its income subject to California tax through the mere act of borrowing. If Hunt-Wesson is successful, it will have succeeded in improperly using the Constitution as a shield, not against improper taxation, but against constitutionally permissible taxation. Historically, this Court has repeatedly affirmed the principle that interstate commerce may be made to pay its fair share of taxation without running afoul of the Commerce Clause. Hunt-Wesson should not be constitutionally permitted to depart from this well-established principle.<sup>11</sup>

## ARGUMENT

### I.

#### **CALIFORNIA'S INTEREST OFFSET STATUTE, WHICH ALLOCATES A CORPORATION'S INTEREST EXPENSE TO ITS BUSINESS AND NONBUSINESS INCOME IN A RATIONAL AND FAIR MANNER, DOES NOT TAX INCOME EXEMPT FROM STATE TAXATION**

It is a well-settled principle of constitutional jurisprudence that a taxing jurisdiction bears no obligation to allow a tax deduction for an expense relating to income which that jurisdiction is barred from taxing. Indeed, Hunt-Wesson itself "takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce." Pet. Br. at 23. Hunt-Wesson nevertheless insists that not one dollar of the indebtedness which generated the more than \$273

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<sup>11</sup> The issues raised in this case have also been raised in *F. W. Woolworth Co. and Kinney Shoe Corp. v. Franchise Tax Board*, No. 98-1967 (Petition for Writ of Certiorari filed June 7, 1999), which is currently pending before this Court.



million of interest expense incurred during the years in issue was attributable in any way to production of the approximately \$75 million of non-taxable dividends by its nonunitary subsidiaries.

In defining the limits to which an expense may be assigned to income not subject to taxation, this Court has repeatedly declared that the immunity from taxation need not be total, but may instead be limited by charging such non-taxable income with its fair share of related expenses. See *Denman v. Slayton*, 282 U.S. 514 (1931) (federal tax statute permitting deduction of interest expense on indebtedness except as to indebtedness incurred to purchase or carry tax-exempt securities upheld as constitutional and reasonable to close tax loophole); *Helvering v. Ind. Life Ins. Co.*, 292 U.S. 371 (1934) (federal tax provisions allowing for deduction of depreciation and expenses of buildings owned by life insurance companies but only on condition that company include in gross income the non-taxable rental value of the space which it occupied upheld as not an improper tax on the tax-exempt rental value, but rather a permissible "apportionment of expenses"); *United States v. Atlas Ins. Co.*, 381 U.S. 233 (1965) (confirmed holdings in *Denman* and *Ind. Life* that "the tax laws may require tax-exempt income to pay its way"); *First National Bank v. Bartow Cty. Tax Assessors.*, 470 U.S. 583 (1985) (state statute limiting deduction of tax-exempt government obligations in determining bank's net worth on which tax was based upheld as constitutional).

Consistent with this principle, the California Legislature enacted California Revenue and Taxation Code section 24344 over 40 years ago on the belief that a corporation doing business in and out of California is entitled to reduce its State tax liability by deducting only that portion of interest costs from indebtedness which is

attributable to the production of income which the State is permitted to tax.<sup>12</sup> This is accomplished by the application of a statutory formula which assigns a corporation's interest expense to income generated from its business and non-business activities.

Under the statute's formula, interest expense is first assigned to and deductible against, on a dollar-for-dollar basis, a corporation's business income to the extent of its interest income generated from business activities. Any remaining interest expense is then attributed to and offset by the corporation's non-business income in the form of dividends and interest. Once this allocation of interest expense to nonbusiness income is completed, the balance, if any, of interest expense is fully deductible against the corporation's business income. By this method, California seeks to fairly and rationally identify that portion of interest expense which is attributable to and deductible against business income apportioned to the State.

The three-step operation of California's interest offset statute can be illustrated by looking at Hunt-Wesson's operations for 1982, one of the years in issue. As a unitary business engaged in business in California and throughout the world, Hunt-Wesson is subject to apportionment of its worldwide business income by formula. In 1982, Hunt-Wesson's total interest expense from its worldwide operations was \$137 million. It earned interest income from its unitary business operations of \$84 million.

Hunt-Wesson also owned dividend-paying subsidiaries, none of which was a member of its unitary business. In 1982, Hunt-Wesson received \$19 million in dividend income from its nonunitary subsidiaries.

Under the first step of the interest offset rule, Hunt-Wesson was entitled to a dollar for dollar deduction of

<sup>12</sup> 1955 Cal. Stat., c. 938, p. 1581, § 20, eff. June 6, 1955.



approximately \$84 million, which is equal to its interest income from its unitary business. This leaves \$53 million in interest expense (\$137 million less \$84 million).

Under the second step, the \$53 million is offset against any nonbusiness interest or dividend income. For Hunt-Wesson in 1982, this reduced the allocable interest expense to \$34 million (\$53 million less \$19 million).

Under the third step, California allows the remaining \$34 million to be deducted, dollar for dollar, against any other apportionable business income. Thus, Hunt-Wesson's total interest expense deduction for 1982 was \$118 million. This amount is available to reduce its total business income. California's apportioned share of total business income is then calculated from this net unitary business income figure.

As earlier noted, the taxation of Hunt-Wesson's non-business income is a matter constitutionally assigned to its state of domicile. Hunt-Wesson is domiciled in Illinois.

California's statutory matching of a corporation's interest expense to its business activities and nonbusiness activities by the measure of its investment income from interest and dividends reasonably reflects how its income is generated. The California Supreme Court has declared:

In treating interest expense as the opposite of investment income (interest and dividend income), the subsection is obviously approaching the problem presented in a reasonable manner. Interest expense is the opposite of interest income, and dividend income is sufficiently analogous to interest income that it is reasonable to provide for the offset of interest expense against dividend income. *Pacific Telephone*, 7 Cal.3d at 551-552, 498 P.2d at 1036.

The California Supreme Court's approval of the Legislature's decision to equate passive income such as interest and dividends with interest expense is rational. Interest

and dividend income represent a source of ready and available cash to a corporation to help defray interest expense. In recognizing the logic of offsetting investment interest and dividend income with interest expense, the California Supreme Court has found that the approach taken by the California Legislature is reasonable. *Id.*

In stark contrast to both the express terms and underlying rationale of section 24344(b), Hunt-Wesson erroneously describes the operation of the statute as first requiring the elimination of nonbusiness interest expense from the interest offset computation. Pet. Br. at 8 & 9. Hunt-Wesson asserts that "under California law, nonbusiness interest expense has already been disallowed as a deduction, and thereby eliminated from the calculus, prior to the application of the interest offset provision." Pet. Br. at 25.

California's statute contains *no such requirement*. Cal. Rev. & Tax. Code § 24344; see *Pacific Telephone*, 7 Cal.3d at 549-550, 498 P.2d at 1034-1035. In applying the interest offset provision to Hunt-Wesson's interest expense for the years in issue, neither Hunt-Wesson nor the Board made any attempt to eliminate "nonbusiness interest expense" from the calculation. See CT 120. If "nonbusiness interest expense" had been removed, application of the formula would have been superfluous because the assignment of interest expense between business and nonbusiness income would have already occurred. Indeed, the matching of interest expense with classes of income is the entire purpose of the statute.<sup>13</sup>

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<sup>13</sup> The Board did *not* stipulate that the elimination of nonbusiness interest expense is a statutory component of the interest offset computation. Hunt-Wesson's assertion to the contrary (Pet. Br. at 8 n. 8) stems from its interpretation of California state tax form Schedule R-5, Form 100, as effective

Similarly, Hunt-Wesson's assertion that the interest offset provision of the California statute is applied only to "business interest expense" (Pet. Br. at 25) is misleading because it assumes that the interest expense being assigned has already been classified as a "business" expense and that none of it relates to nonbusiness income. In essence, Hunt-Wesson is attempting to rewrite the statute with a term of its own creation – "business interest expense" – in an effort to manufacture support for its position. The term "business interest expense" does not appear anywhere in the statute, which refers simply to the allocation of "interest."<sup>14</sup>

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during the years in issue. J.A. 20 (Stip ¶ 11); CT 70. This form erroneously instructs the taxpayer to identify and subtract its nonbusiness interest expense prior to determining the amount of interest expense attributable to business and nonbusiness income. Although the Board has determined that the form in use during the years in issue does not correctly implement the provisions of the statute and that the form has since been corrected, any confusion created as a result is not constitutionally significant. This Court has held that a taxing agency is empowered retroactively to correct mistakes of law in its application of tax statutes to particular transactions. See *Dixon v. United States*, 381 U.S. 68, 72-73 (1965); *Automobile Club v. Commissioner*, 353 U.S. 180, 183-84 (1957). This reflects the fact that the California Legislature, not the Board, prescribes the State's tax laws. *Dixon*, 381 U.S. at 73. Hunt-Wesson's challenge is directed to the constitutionality of section 24344(b) itself and not to the provisions of state tax form Schedule R-5. In any event, the amount of tax in dispute here is unaffected by any such ambiguity because Hunt-Wesson reported *all* of its interest expense as business interest expense and *none* of it as nonbusiness interest expense. J.A. 19-20 (Stip. ¶ 10).

<sup>14</sup> Although California stipulated that the interest expense reportable on line 3 of state form Schedule R-5 is "business interest expense," it did *not* stipulate that the interest expense bore no relation to the non-taxable dividend income. J.A. 20

**A. California's interest offset statute is based on the rationale that money is fungible and cannot be reliably traced to its ultimate use**

When a corporation engaged in business both in and out of California incurs debt while simultaneously holding investments which generate non-taxable income, the question arises as to what extent, if any, the corporation should be allowed by the State to deduct the interest costs from the indebtedness. California generally permits a corporate taxpayer to deduct from gross income the interest paid or accrued within the taxable year on indebtedness as an expense incurred in the production of taxable income. Cal. Rev. & Tax. Code § 24344(a). However, if a deduction of the *entire* amount of interest expense is allowed, the corporation stands to gain a tax windfall by reducing its California business income by the full amount of the interest costs, regardless of whether those costs include expenses related to the production of non-taxable income, while at the same time shielding its non-taxable income from State taxation.<sup>15</sup>

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(Stip. ¶ 11). California furthermore did not stipulate as to the meaning of this term, which is neither defined in the stipulation nor is a part of the statute. The characterization of interest expense subject to the interest offset provision as "business interest expense" is consistent with the calculation format contained in state form Schedule R-5. See CT 70. However, as previously noted, state form Schedule R-5 is not consistent with the statutory formula under consideration here and has since been corrected.

<sup>15</sup> The interest expense deduction reflects California's intent to tax only a corporation's net income rather than gross income. The basis for the interest deduction is undermined when the indebtedness giving rise to the interest expense relates to the generation of income which is non-taxable. Accordingly, California precludes a corporate deduction for any expense



This incongruous result stems from the judicially recognized economic relationship which exists between the interest costs of indebtedness and non-taxable income, a relationship which allows a foreign corporation, such as Hunt-Wesson, to finance its unitary business operations on borrowed capital while at the same time earning non-taxable income by investing its own capital in nonunitary investments. *Pacific Telephone*, 7 Cal.3d at 555, 498 P.2d at 1039. The problem facing California is determining as a practical matter the extent to which the corporation's interest expense is attributable to its California unitary business income and to its nonunitary nonbusiness income.

There is no scientifically precise way to make this determination. Money, by its very nature, is fungible and easily subject to manipulation. To illustrate, assume that a foreign corporation engaged in business both in and out of California is subject to a relatively higher California tax rate than in the other states in which it does business. For tax purposes, it would be advantageous for the corporation to decrease its California income attributable to its business activities and increase its non-taxable investment income. If the corporation borrowed money to invest in stocks and bonds, the interest expense from the indebtedness would be chargeable against the non-taxable income from these investments. However, the corporation might choose instead to purchase the securities with funds which would otherwise be used in its business and then later replace such funds with borrowed money. By this simple expedient, the corporation could

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allocable to income not subject to tax by the State. Cal. Rev. & Tax. Code § 24425.

convert what is in reality an expense attributable to non-business income into an expense of doing business and thereby gain a double tax benefit.

Moreover, regardless of a corporation's motive for incurring debt, the accurate tracing of borrowed funds to their ultimate use is virtually impossible. Borrowed funds are typically applied to a variety of general corporate purposes which inevitably encompass both business and nonbusiness activities. A corporation also maintains substantial flexibility as to both the source and use of its funds. The realities of business finance are such that the amount and timing of borrowing rarely, if ever, directly correlate to specific investments, especially where financial transactions are spread out over a number of years.

For these reasons, interest costs cannot be readily traced to a specific business or nonbusiness activity. Typically, as in this case, a corporation will attempt to deduct the entire amount of its interest expense by attributing all of it to the production of its business income and none of it to the production of its nonbusiness income. As a result, the nonbusiness income associated with a portion of the interest costs are not taxed at all, while the interest costs relating to nonbusiness activities are deducted against business income that would be otherwise taxable.

**B. This Court's decisions relating to the unitary business principle and the formula apportionment of income among the states provide a proper analytical framework by which to evaluate California's statutory approach to allocating interest expense to business and nonbusiness income**

This Court has declared that the constitutionality of a state tax statute "requires an examination of the whole tax structure of the state." *Washington v. United States*, 460 U.S. 536, 542 (1983) (internal quotation marks deleted).

Because California's interest offset statute by its terms applies only to a corporation engaged in a unitary business whose income is subject to tax both in and out of California, its constitutionality cannot be properly analyzed in isolation. The California statute is part of a comprehensive tax scheme by which Hunt-Wesson's business income is apportioned among all of the states in which it conducts business pursuant to an apportionment formula which this Court has constitutionally approved. *Container Corp.*, 463 U.S. at 180-84. Just as the revenue derived from a unitary business is not confined to a single state, so too are the costs of production of that revenue unitary in nature. For this reason, the statute may be fairly evaluated by reference to this Court's jurisprudence relating to the unitary business principle and the formula apportionment of income.<sup>16</sup>

In *Container Corp.*, this Court upheld California's three-factor apportionment formula as a reasonable, albeit "necessarily imperfect," method of assigning income among the various components of a unitary business. *Id.* at 183. In doing so, this Court recognized that precise allocation of taxable items of corporate income among the various taxing jurisdictions in which a unitary business conducts its activities is "often an elusive goal, both in theory and in practice." *Id.* at 164. This Court has observed that "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow." *Id.* at 192. Accordingly, this Court has long refused to impose a single method of formula apportionment of income on the states. *Id.* at 164.

<sup>16</sup> "A state tax must be assessed in light of its actual effect considered in conjunction with other provisions of the State's tax scheme." *Maryland v. Louisiana*, 451 U.S. 725, 756 (1981).

Instead, this Court has stated that the Constitution requires states only to be "fair" in applying an apportionment formula to determine how much of a corporation's income may be taxed. The fact that the precision by which income is apportioned to each state may be somewhat imperfect does not alone violate the Constitution. *Amerada Hess Corp. v. N. J. Taxation Div.*, 490 U.S. 66, 74 (1989). "The Constitution does not invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State." *Container Corp.*, 463 U.S. at 169-170 (internal quotation marks deleted).

Under formula apportionment, the fairness of a taxing provision is determined not by the effect of that provision on the amount of tax paid in one state, but on the amount of tax cumulatively paid in all states in which the corporation does business. If the amount of tax to which a multistate corporation is subjected approximates 100 percent of its tax base, fairness is achieved. *Id.* A "rough approximation" of a taxpayer's activities in the taxing state has been held sufficient in the formula apportionment of income from a unitary business. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978). Furthermore, only if the taxpayer can demonstrate by "clear and cogent evidence" that income attributed to a particular state is "out of all appropriate proportions to the business transacted . . . in that State" or has "led to a grossly distorted result" will this Court invalidate an apportionment formula. *Container Corp.*, 463 U.S. at 170.

The same considerations which led this Court to approve formula apportionment as a rational way to fairly assigning net income among various states are equally applicable to California's statutory formula for assigning interest expense to various classes of income. Both formula apportionment and California's allocation



formula were developed in response to the inherent difficulties of tracking income and expenses to their proper origin in a unitary business context. In the same way that income from a unitary business cannot be readily traced to a specific source, expenses incurred by a unitary business similarly cannot be readily traced to its ultimate application. Moreover, direct tracing of indebtedness to its ultimate use suffers from the same inherent weaknesses as formal geographical accounting in the context of formula apportionment: Both are subject to manipulation and precision and yield unreliable results. *See id.* at 164. Based on its previous discussion of these various issues, this Court's decisions in the area of formula apportionment provide a valid framework by which to evaluate California's formula for allocating interest expense.

**C. California's interest offset statute satisfies this Court's "fairness" test of internal consistency**

This Court declared in *Container Corp.* that the first component of fairness is whether the allocation formula has "internal consistency," such that if the apportionment formula was applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed. *Id.* at 169. The application of the "internal consistency" test does not depend on whether states other than the taxing state have in fact imposed a similar tax. *See Armco Inc.*, 467 U.S. at 644-45; *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 247 (1987).

Subjecting California's interest offset statute to the same constitutional scrutiny which this Court applied to California's apportionment formula in *Container Corp.*, it is apparent that the manner by which the State allocates interest expense between business and nonbusiness income is constitutionally "fair." If every jurisdiction in

which Hunt-Wesson was taxable utilized an interest offset statute identical to California's, Hunt-Wesson would realize the full benefit of each dollar of interest expense which it incurred during the years in issue. To the extent that Hunt-Wesson's interest expense was attributed to its nonbusiness dividend income, thereby increasing its apportionable business income, the offset interest expense would be recognized and have the effect of reducing its tax liability in Illinois, its State of domicile.

**D. California's interest offset statute satisfies this Court's "fairness" test of external consistency by providing a reasonable sense of how Hunt-Wesson's income was generated**

This Court has also required a showing of "external consistency" as a component of fairness in the context of formula apportionment. *Container Corp.*, 463 U.S. at 169. External consistency requires that the factors used in the formula actually reflect a reasonable sense of how income is generated. *Id.* This test is also satisfied here.

As the California Supreme Court has recognized, interest expense bears a sufficient economic relationship to dividend income not taxable by California to justify the offsetting of one with the other. *Pacific Telephone*, 7 Cal.3d at 551-552, 498 P.2d at 1036. That relationship is based on the fungible nature of money and its potential for manipulation and substitution. The statute is premised on the belief that a corporation should not receive a full deduction for its interest costs when it invests in non-taxable activities with business funds which necessitated the borrowing in the first place. It aims to foreclose a state-subsidized tax advantage to a corporation over its competitors by equalizing the tax effect between a corporation that borrows money to enable it to earn non-taxable investment income and one which utilizes all of its funds



exclusively for business purposes without holding such investments.

Consider, for example, a corporation which, in the same year, (1) invests some of its available funds in a nonunitary subsidiary and (2) elects to incur debt to finance its business operations for that year. Inasmuch as the corporation could have reduced or even avoided the debt had it not tied up its funds in nonbusiness activities but instead used the funds to finance its business, it is highly questionable whether the company's business activities are truly the origin of the interest expense incurred. Thus, even where there is no direct or historical link between the purchase of nonbusiness assets and the loans on which interest expense is paid, it is reasonable to consider interest expense as the cost of obtaining interest and dividend income from nonbusiness securities regardless of the nominal purpose for which the money is borrowed.

Rather than allocating interest expense based on the value of business and nonbusiness assets, as some other states do, California takes a more direct, but equally rational, approach to "leveling the playing field" by eliminating a tax advantage to a corporation which incurs corporate debt when it has otherwise available funds of its own invested in securities and bonds. In this manner, the statute rationally and effectively ensures that a corporation that borrows money to enable it to earn nonbusiness income through investments will not pay less California tax than a corporation which owns no such investments but has incurred indebtedness to finance its business operations.

Hunt-Wesson itself impliedly concedes the existence of the relationship between interest expense and non-taxable dividend income by its citation to a variety of

"fair" and "presumptively constitutional" allocation methods which aim to assign interest expense by reference to nonbusiness activities. Pet. Br. at 28-32. Furthermore, the fact that each of these endorsed "reasonable" alternative methods utilizes a mechanical formula for assigning interest expense evinces Hunt-Wesson's tacit acknowledgement of the inherently fungible nature of money.

Hunt-Wesson's reliance on *Nat. Life Ins. Co. v. United States*, 277 U.S. 508 (1928) is inapposite. That case involved a deduction – measured by a percentage of an insurance company's "reserve funds required by law" reduced by the amount of interest income from tax-exempt securities – which was neither directly nor indirectly related to the receipt of tax-exempt interest income. Unlike an interest expense deduction from indebtedness which can be utilized with complete discretion, a deduction arising from an insurance reserve fund entails the use of money for a specific and limited purpose. Because financing the reserve fund was "required by law," it had no utility beyond the purpose of the fund itself. The funds contained in the reserve could not be manipulated, regardless of the origin of the money. Thus, once money was deposited into the reserve fund, the money lost its fungibility as well as any economic relationship to the tax-exempt income.<sup>17</sup>

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<sup>17</sup> To further illustrate, a corporation may elect to purchase an apartment building as an investment property. It may purchase the nonbusiness asset with either available cash or by incurring debt, which is subject to manipulation with respect to the allocation of interest expenses. However, once the apartment building is purchased, the depreciation is the same nonbusiness expense deduction regardless of the origin of the funds used to acquire it.

In contrast, Hunt-Wesson's decision to invest money in nonbusiness assets and the decision as to which funds to finance that investment were wholly discretionary. California's statute is premised on the economic reality that borrowed funds can be used for a variety of purposes and in a manner the ultimate disposition of which cannot be ascertained with ease. It is this potential for manipulation which distinguishes interest expense from other forms of deductions.

**E. California's interest offset statute evenhandedly allocates interest expense between business and nonbusiness income**

California's statute is furthermore constitutional because it assigns interest expense to business and nonbusiness income in an evenhanded and neutral manner. The statute does not require a corporation to demonstrate that interest expense is in fact attributable to the production of business income before it is allowed as a deduction. Similarly, California does not require a showing that interest expense which has been matched with nonbusiness income is in fact related to investment activities. In each instance, the statute reflects a legislative recognition that money is fungible and cannot be traced accurately to its ultimate use. Attempting to trace a corporation's source of funds and interest expense in every case would not only be administratively prohibitive but would lead to less than reliable or accurate results.

Accordingly, Hunt-Wesson's claim that "no portion of the proceeds of the loans . . . went *directly* to any non-unitary corporation" (emphasis added) during the years

in issue elevates form over substance.<sup>18</sup> Pet. Br. at 5. The fact that the borrowed funds are not directly traceable to Hunt-Wesson's investment activities is neither constitutionally nor economically relevant. This is because, regardless of the ultimate use of the borrowed funds, the potential for manipulation inherent in money necessarily creates a rational connection between Hunt-Wesson's indebtedness and its nonbusiness income.<sup>19</sup>

Furthermore, if Hunt-Wesson had incurred debt for the sole purpose of making direct loans to its *nonbusiness* activities, the interest expense incurred from the indebtedness would be likewise subject to assignment under the interest offset statute. As a result, a portion of that interest expense would be available to reduce Hunt-Wesson's taxable *business* income. Given the fungible nature of money, such an allocation would be rational on the theory that the borrowed funds made available other

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<sup>18</sup> Hunt-Wesson's assertion implies, of course, that there may have been an *indirect* relationship between the loans and the foreign subsidiaries. Indeed, no evidence exists that Hunt-Wesson incurred the debt for the sole purpose of financing its business operations.

<sup>19</sup> Thus, using Hunt-Wesson's example set forth at page 35 of the Brief for Petitioner, it is not economically significant that the proceeds of the loan from which interest expense was paid were used to purchase business manufacturing machinery rather than for nonbusiness purposes. Had the money which the corporation elected to invest in its dividend-producing nonbusiness subsidiary in Outer Mongolia been used instead to purchase the business machinery, there would have been no need for the loan on which interest expense was incurred to begin with. In any event, no evidence exists in this case as to the specific purpose for which the borrowed funds on which Hunt-Wesson incurred interest expense were in fact used.



existing funds for the corporation to apply to its business operations.

In fact, one might even contend that California "over-allocates" interest expense to *business* income. This is reflected in the ordering component of the statute which at the outset allocates interest expense to business income to the full extent of interest income from business activities. Thus, had the amount of Hunt-Wesson's business interest income during the years in issue equalled or exceeded its total interest expense, *all* of the interest expense would have been attributed to and deductible against its business income, regardless of the amount of nonbusiness dividend income generated. Furthermore, under the statute, California permits a deduction for any remaining interest expense in excess of nonbusiness interest and dividends, thus providing for an additional reduction of business income.

It is also important to note that the allocation of one dollar of Hunt-Wesson's total interest expense to non-business income does not result in a one dollar increase in its income subject to California tax. As a multistate corporation engaged in a unitary business, Hunt-Wesson's net business income is apportioned among all states in which it engages in business. As a result, an interest offset of one dollar to nonbusiness income will result in only an *apportioned* increase in California taxable income. For example, if only 15 percent of Hunt-Wesson's net business income is apportioned to California under its apportionment formula, then an interest offset of one dollar against nonbusiness income would result in only a 15 cent increase in business income apportioned to California.

**F. The states should not be constitutionally compelled to adopt a uniform method of allocating interest expense to the exclusion of other methods**

Hunt-Wesson seeks to have this Court "constitutionalize" the manner by which states are permitted to allocate interest expense deductions between taxable and non-taxable income. Hunt-Wesson alleges that other taxing jurisdictions utilize "fair" and "reasonable" statutory and regulatory allocation formulas by relating interest expense to non-taxable activities in a manner which differs from California's approach. For this reason, Hunt-Wesson suggests, the California statute must be unconstitutional. Hunt-Wesson's position is spurious.

First, in the analogous context of formula apportionment, this Court has refrained from *requiring* states to adopt a uniform apportionment formula under the Constitution. *Container Corp.*, 463 U.S. at 171; *Moorman Mfg. Co. v. Bair*, 437 U.S. at 278-80. "[A] fairly apportioned tax [will] not be found invalid simply because it differed from the prevailing approach adopted by the States." *Container Corp.*, 463 U.S. at 171. Similarly, nothing in the Constitution *requires* all states to uniformly follow a particular formula for assigning interest expense. Whether or not an allocation formula exists elsewhere which is arguably "better" or "fairer" than California's statute is not constitutionally significant. It is for each state's legislature to determine whether to follow or diverge from the prevailing approach followed by other states. California's approach must be therefore evaluated on its own merits.

Second, Hunt-Wesson fails to provide any explanation as to how or why any of the alternative methods which it has embraced more "fairly" or "rationally" allocate interest costs to classes of income. Nor has Hunt-Wesson offered any proof to this Court that it would have

been entitled to deduct more interest expense from its business income under any of these alternative formulas.

Third, it is at least debatable whether any of the alternative allocation methods truly differ in substance from California's approach. Similar to the California statute, these methods assign interest expense to business income by a formula which takes into account nonbusiness activities.<sup>20</sup> The allocation formulas furthermore recognize (1) the fungible nature of money, and (2) the economic relationship between a corporation's interest expense and its level of non-taxable activity. The precision by which these methods relate interest expense to business and nonbusiness activities may also be subject to criticism.<sup>21</sup> However, if nothing else, Hunt-Wesson's high

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<sup>20</sup> Hunt-Wesson's reliance on the administrative decision of the California State Board of Equalization ("SBE") in *Appeal of Zenith Nat'l Ins. Corp.*, 1998 Cal. Tax LEXIS 1, 4 Cal. St. Tax Rep. (CCH) ¶ 402-965 is unavailing. First, the SBE's decision did not involve an interpretation of Cal. Rev. & Tax. Code § 24344, but rather Cal. Rev. & Tax. Code § 24425. Second, the SBE acknowledged that the Board's argument that interest expense is not susceptible to direct tracing because of the fungible nature of money was "valid." Third, although the SBE, over the Board's objections, interpreted section 24425 as authorizing direct tracing, it did so only on the basis of similar language contained in section 265 of the Internal Revenue Code. I.R.C. § 265. Finally, nothing in section 24425 itself suggests that the California Legislature intended to incorporate direct tracing as a means of implementing the terms of the statute. Nor has the Legislature seen fit to modify section 24344 in response to *Zenith*.

<sup>21</sup> For instance, the assignment of interest expense on the basis of the value of nonbusiness assets is potentially problematic. Under this method, the amount of interest expense attributed to nonbusiness activities increases as the value of the investment asset increases, even though the amount of funds used to purchase the asset is unchanged. There also exist difficulties in determining the value of those assets. It is

regard for these "rational" alternative allocation formulas may be fairly viewed as an implied acknowledgement that an interest expense deduction which is determined by reference to non-taxable investment activities does *not* necessarily amount to the taxation of non-taxable income.

Finally, Hunt-Wesson's endorsement of these alternative formulas is less than candid. It does not ask this Court to permit it to recalculate its interest expense deduction by any one of the alternative "fair" allocation methods which it embraces. Nor does it contend that, to the extent that some of the alternative provisions permit direct tracing, it is capable of tracing every dollar of debt which it incurred during the years in issue to business-related activities. Rather, it seeks the best of both worlds – not only to have this Court invalidate California's statute but to also reduce its California business income by the *full* amount of its interest costs without any allocation or any showing that they were in fact attributable to the production of business income. It continues to maintain, without hint of compromise, that none of the more than \$273 million in interest expense incurred during the years in issue was in any way related to the approximately \$75 million of nonbusiness dividends which its investments generated.

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administratively impractical to base an asset's value on fair market value because of the need for appraisals, sometimes for assets located around the world, in order to obtain the most accurate measure of interest expense. On the other hand, the valuation of assets by the measure of depreciated basis may be significantly lower than the valuation based on fair market value.



**G. No indirect tax on non-taxable income results from California's inclusion of Hunt-Wesson's nonbusiness dividend income in the allocation of Hunt-Wesson's interest expense under the interest offset statute**

Hunt-Wesson contends that California's statute indirectly taxes a corporation's nonbusiness income which is immune from taxation.<sup>22</sup> This claim must be rejected.

First, California does not seek to tax, either directly or indirectly, Hunt-Wesson's nonbusiness income. Rather, California seeks to tax only its share of Hunt-Wesson's business income, as measured by the deduction of only that portion of interest expense which is attributable to the production of business income. The California Legislature's interest in taxing only business income is reflected in the statute's ordering rule, which at the outset allocates a corporation's interest expense to business income to the full extent of its business interest income, regardless of the amount of its nonbusiness income. Thus, a foreign corporation which has no California business income, but receives only non-taxable nonbusiness income during a taxable year, will incur no California tax liability, regardless of the amount of interest expense which would be allocated to nonbusiness income under the statute. Hunt-Wesson's objection thus boils down to little more than an attack on the amount of tax which California has imposed on its business income, which the State is indisputedly permitted to tax.

<sup>22</sup> The record contains no evidence that the dividends in question were actually taxed in full as nonbusiness income in Hunt-Wesson's state of domicile. Moreover, no evidence exists that Hunt-Wesson even reported the dividends as business income in its state of domicile.

Second, as the California Supreme Court correctly concluded in *Pacific Telephone*, the inclusion of non-taxable dividends in the interest offset calculation is not tantamount to the indirect taxation of such dividends. *Pacific Telephone*, 7 Cal.3d at 555, 498 P.2d at 1038.<sup>23</sup> The mere fact that the interest expense deduction against business income is reduced by the amount of the interest offset does not mean that non-taxable income is being taxed. If consideration of a corporation's nonbusiness activities in calculating the amount of business income subject to state tax means that its nonbusiness income is being taxed, then practically all interest expense allocation methods would be vulnerable to constitutional challenge. This would include the "presumptively constitutional" allocation methods identified by Hunt-Wesson which assign interest expense to related income by reference to the ratio of nonbusiness income to total income as well as by reference to the ratio of the value of nonbusiness assets to total assets. Pet. Br. at 28-32. A statute that simply matches expenses with taxable income by reference to non-taxable income does not convert the statute into an unconstitutional tax on non-taxable income.

Third, although it is literally true that the reduction of Hunt-Wesson's California interest expense deduction was "due entirely" to its nonbusiness dividends, it is *not* true that Hunt-Wesson's interest expense and dividend income are unrelated. The statute matches interest expense with classes of income in such a manner that, by necessity, will increase Hunt-Wesson's apportionable

<sup>23</sup> See *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 312 n. 10 (1994) (approximating California income through formula apportionment by reference to non-California income does not constitute taxation of non-taxable income).



business income because it could not reduce its business income by the full amount of its interest expense. However, this is simply the result of charging non-taxable income with its fair share of burdens. A corporation which borrows money to finance its business operations when it simultaneously has its own funds invested in non-taxable securities is not constitutionally entitled to pay less tax than a corporation without such investments. Conversely, due process does not require a corporation that holds no non-taxable investments to bear a heavier tax burden than one that does hold such investments.

Fourth, although the Constitution protects Hunt-Wesson's nonbusiness dividend income from the burden of taxation in California, it does not afford to it an entitlement to deductions stemming from expenses attributable to such income. Hunt-Wesson cannot be allowed to complain that it has not been made the full recipient of more favorable tax treatment which the California Legislature has not authorized and which this Court is not constitutionally mandated to give.

During the years in issue, California's interest offset statute had been already in existence for over 20 years. Hunt-Wesson was well-aware of its operation and was free to choose the manner by which to structure its financial affairs. Once having done so, it is bound by the tax consequences of that choice, whether intended or not, and may not benefit from some other path which it might have chosen to follow but did not. *See Commissioner v. Nat. Alfalfa Dehydrating*, 417 U.S. 134, 148-49 (1974).

In the final analysis, California's statute attempts to do nothing more than assign expenses between taxable income and non-taxable income in order to determine the extent to which a deduction should be allowed against business income which the State is entitled to tax. While Hunt-Wesson is constitutionally entitled to protection

from the taxation of non-taxable income, California is just as entitled to protect itself from unfair tax avoidance. California's statute does nothing more than require Hunt-Wesson to pay its own way. As such, it is fully consistent with due process.

## II.

### CALIFORNIA'S INTEREST OFFSET STATUTE DOES NOT FACIALLY DISCRIMINATE AGAINST INTER-STATE COMMERCE ON THE BASIS OF DOMICILE

Hunt-Wesson contends that California's interest offset statute violates the Commerce Clause because it facially "discriminates against nondomiciliary corporations in favor of domiciliary corporations" in that the "allowance or disallowance of the [interest expense] deduction turns entirely on the domicile of the dividend-receiving corporation." Pet. Br. at 33 & 37. Hunt-Wesson's claim is meritless.

A facial challenge to a statute requires a showing by the claimant that the statute could not be constitutional under any existing circumstances.<sup>24</sup> *United States v. Salerno*, 481 U.S. 739, 745 (1987). Hunt-Wesson has failed to meet its heavy burden of proving discrimination.

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<sup>24</sup> In most of this Court's recent cases striking down statutes because they facially discriminated against interstate commerce, the legislature that enacted the offending statute can fairly be said to have had a discriminatory intent. In contrast, Hunt-Wesson does not contend in its Brief for Petitioner that the statute before this Court reflects a discriminatory intent on the part of the California Legislature. Although a letter from former California Governor Knight, prior to the signing of the legislation enacting the statute, describes the likely consequence of the statute, Hunt-Wesson has not pointed to any legislative intent to discriminate against foreign corporations. *Pacific Telephone*, 7 Cal.3d at 554, 498 P.2d at 1038.

California's statute, whether viewed as a collection of parts or as a totality, is facially neutral. Nothing in the language of the statute compels the assignment of interest expense on the basis of domicile.<sup>25</sup> The statutory ordering rule is applied in the same manner and with equal force to both domestic and foreign corporations.

Discrimination, for constitutional purposes, is prohibited only as to taxpayers which are similarly situated. See *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997). In order to prove discrimination, Hunt-Wesson must identify an appropriate comparison class of the most similarly situated taxpayers and demonstrate that the tax treats the members of one class more favorably than the other.

Hunt-Wesson claims that the basis for discrimination lies between domestic and foreign corporations. In reality, the constitutionally relevant basis for comparison is between corporations that operate on borrowed money while simultaneously holding investments which generate income exempt from California tax and corporations that do not hold such investments and devote their entire capital to their business operations, thereby reducing or eliminating the need to incur debt.

The so-called discriminating treatment is not tied to domicile, but in fact to the character of income to which interest expense is assigned. The statute aims to ensure that a corporation that invests in nonbusiness activities while operating on borrowed funds and a corporation that operates on its own capital without such investments are similarly situated for state tax purposes. In this manner, the assignment of interest expense to business

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<sup>25</sup> As previously noted, it is not universally true that domicile is the operative component in California in determining where nonbusiness income is taxable. See Cal. Rev. & Tax. Code, §§ 25123-25127.

income does not discriminate against non-domiciled corporations – the amount assigned to nonbusiness income is the same regardless of where the corporation is domiciled – but simply places the two corporations on the same footing.

The fact that the character of Hunt-Wesson's income and not its domicile is the controlling component of the statute can be readily illustrated. If, for example, Hunt-Wesson had received no investment interest or dividend income during the years in issue, *all* of the interest expense would have been available to reduce its apportionable business income regardless of where it is domiciled. Similarly, if Hunt-Wesson's interest expense during the years in issue had equalled or not exceeded its business interest income, the entire amount of interest expense would have been available under the statute to reduce its apportionable business income. This would have been so even though Hunt-Wesson is domiciled outside of California.

Discrimination is not established simply because there may exist some geographical implications to the application of California's statute. The chance that the assignment of interest expense to classes of income taxable outside the State may work to the disadvantage of corporations not domiciled in California is, as Hunt-Wesson itself acknowledges, "nothing more than a description of the natural consequences of allowing an interest expense deduction that corresponds to the State's power to tax nondomiciliary and domiciliary taxpayers' income." Pet. Br. at 34.

When viewed in the context of income apportionment, the flaw in Hunt-Wesson's claim that the California statute favors domestic corporations over foreign corporations is even more evident. California's matching of a corporation's interest expense with nonbusiness income



taxable in its state of domicile does not deprive the corporation of the full benefit of that expense in reducing its overall worldwide tax liability. Rather, consistent with unitary principles, the California statute simply assigns interest expense to business and nonbusiness income, so as to more accurately reflect the origin of that expense. As a result, to the extent that the assignment of interest expense to nonbusiness income, which is itself allocated to the corporation's domicile, leads to an increase in income subject to tax by California, a corresponding decrease in taxable income occurs in the state of domicile. In this manner, California neither imports revenue nor exports burdens to other states in violation of interstate commerce.

This Court has held that income which is fairly apportioned to a taxpayer's activities in the state eliminates the risk that it will subject interstate commerce to a multiple tax burden not borne by local commerce. The anti-discrimination principle of the Commerce Clause "has not in practice required much in addition to the requirement of fair apportionment." *Container Corp.*, 463 U.S. at 171.

This Court has also interpreted the Commerce Clause to require a tax statute to have "internal consistency." *Armco Inc.*, 467 U.S. at 644; *Container Corp.*, 463 U.S. at 169. The internal consistency principle implements the view that the Commerce Clause forbids taxes that penalize taxpayers merely because they do business across state lines. Whether internal consistency exists does not depend on whether states other than the taxing state have in fact imposed a similar tax. *Tyler Pipe Inds. v. Dept. of Revenue*, 483 U.S. at 247; *American Trucking Assns. v. Scheiner*, 483 U.S. 266, 282-84 (1987).

Here, as previously noted, California's statute passes the "internal consistency" test. If every state in which

Hunt-Wesson was taxable utilized a statute identical to California's interest offset statute, Hunt-Wesson would realize the full benefit of each dollar of interest expense which it had incurred. Any decrease in Hunt-Wesson's interest expense allocable to California as a result of the assignment of interest expense to nonbusiness dividend income would result in a corresponding increase in its interest expense allocable to Illinois, its State of domicile. In this manner, Hunt-Wesson would not bear any burdens greater than its domestic counterpart.

The fact that the State of Illinois does not have a statute identical to California's interest offset statute does not invalidate the internal consistency test. The constitutionality of a tax statute does not "depend on the shifting complexities of the tax codes of 49 other States" and "the validity of the taxes imposed on each taxpayer [does not] depend on the particular other States in which it operated." *Armco Inc.*, 467 U.S. at 645. It is undesirable, as a matter of principle, to create a rule a law that depends for its operation on the present configuration of statutes of other states.<sup>26</sup>

Moreover, the extent to which Hunt-Wesson is adversely affected in California is not attributable to any defects inherent in the statute. California applies the statute equally to both California corporations and non-California corporations doing business in the State. Any disparity results from the combined effect of the California statute and the absence of an identical statute in Hunt-Wesson's state of domicile. Yet, California cannot, and should not, be held accountable for the latter.

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<sup>26</sup> Such a rule of law would also be disfavored as a matter of practice. Not only would states encounter compliance and administrative difficulties in tax collection, taxpayers would also face uncertainties in determining their state tax liabilities.

In the final analysis, Hunt-Wesson's characterization of the effect of California's statute as "discriminatory" is nothing more than a way of describing the consequences of the absence of uniformity between California and Illinois tax laws. Such consequences could be readily eliminated if Illinois adopted a statute identical to California's. However, on its own terms, California's statute is not inherently discriminatory.

### III.

#### IN THE PARENTHETICAL PROVISIONS OF CALIFORNIA'S INTEREST OFFSET STATUTE, DIVIDENDS DECLARED FROM INCOME ALREADY INCLUDED IN THE MEASURE OF CALIFORNIA'S TAX ARE UNIFORMLY EXCLUDED FROM THE INTEREST OFFSET FORMULA

Turning away from the principal components of California's interest offset statute, Hunt-Wesson lastly complains about the parenthetical provisions of the allocation formula. In doing so, Hunt-Wesson seeks to draw this Court into an unnecessary constitutional discussion of a separate and complex statute, one which is currently under challenge in the California courts.<sup>27</sup>

Under California's interest offset statute, once interest expense is assigned to apportionable business income to the extent of business interest income, any remaining interest expense is deductible against apportionable business income to the extent that interest expense exceeds nonbusiness interest and dividend income. However, the statute parenthetically excludes from this calculation all "dividends deductible under the provisions of Section 24402." Dividends deductible under section 24402 of the

<sup>27</sup> *First Credit Bank & Subsidiary v. Franchise Tax Board*, Los Angeles County Superior Court, No. BC205481.

California Revenue and Taxation Code consist of dividends "declared from income which has been included in the measure of" the California tax of the dividend declarant.

Hunt-Wesson contends that California's interest offset statute is discriminatory because it impermissibly favors in-state over out-of-state investment by affording a foreign corporation a greater deduction of interest expense against business income "to the extent that the dividends [are derived] from corporations that are taxable in California." Pet. Br. at 38. This contention lacks merit.

First, Hunt-Wesson's claim must be rejected at the outset because it has failed to identify the proper comparison classes by which to evaluate its claim of facial discrimination. Hunt-Wesson attempts to distinguish between foreign corporations that invest in companies whose earnings are derived from out-of-state activities and foreign corporations that invest in companies whose earnings are derived from in-state activities. Yet, as between these two classes of corporations, California's interest offset statute is applied in exactly the same manner and to the same extent - in each instance, all dividends declared from income already subjected to California tax are excluded from the interest offset computation.

In reality, Hunt-Wesson's complaint is not with the interest offset statute at all, but rather with the fact that the amount of excluded dividends as determined by section 24402 may vary according to the level of in-state activity of the dividend payor. However, this occurrence results not from the operation of the interest offset provision, but rather from the operation of section 24402 itself. Any finding in favor of Hunt-Wesson on this question



would necessitate a determination that section 24402 itself is unconstitutional.

Because Hunt-Wesson's complaint is in truth little more than a disguised attack on the constitutionality of section 24402 itself, this Court is not compelled to address it in this case. It is questionable whether the constitutionality of section 24402 is properly present in this litigation. Hunt-Wesson has not expressly challenged the constitutionality of section 24402 in its complaint. J.A. 4-11. The sole basis for Hunt-Wesson's complaint is the constitutionality of section 24344 of the California Revenue and Taxation Code. Furthermore, Hunt-Wesson does not allege anywhere in its Brief for Petitioner that section 24402 itself is unconstitutional.

Second, even if Hunt-Wesson is permitted to contest the constitutionality of section 24402, its challenge must fail. In *Fulton Corp. v. Faulkner*, 516 U.S. 325, on which Hunt-Wesson relies, the North Carolina intangibles tax on the value of stock held by North Carolina resident shareholders was struck down as facially discriminatory. In so holding, this Court ruled that the tax could not be upheld as compensatory to the general corporate income tax imposed on the issuing corporation doing business in the State. No burden on intrastate commerce could be identified for which the intangibles tax allegedly compensated. Any comparison between the size of the intangibles tax and the general corporate income tax was impossible because the two taxes were based on different events. Furthermore, the two taxes failed to fall on the same class of taxpayers.

In contrast, the deduction of dividends under section 24402 is intended "to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation." *Pacific Telephone*, 7 Cal.3d at 548 n. 4, 498

P.2d at 1034 n. 4. As the California Court of Appeal found in rejecting Hunt-Wesson's claim, because California had already taxed the dividends in question, no unconstitutional discrimination results from the State's efforts to refrain from double taxation. J.A. 64. Thus, no advantage is afforded to California subsidiaries over foreign subsidiaries. The exemption does nothing more than compensate for the earlier taxation of the dividend-producing income by California, thereby eliminating the chance that such income might be subjected to taxation more than once.<sup>28</sup>

By limiting the amount of the dividend-received deduction to the amount of the subsidiary's earnings that have already been subject to California tax, section 24402 has the effect of equalizing the cost on interstate commerce and intrastate commerce. Whether the corporate payor's earnings which generated the dividends are taxed as income by California to the payor or result in a denial of a dividend deduction to Hunt-Wesson, the income is in either case subject to California tax at the same rate. Conversely, under section 24402, if none of the dividends is permitted as a deduction to the payee, none of the payor's earnings is subject to taxation by California. The net effect is thus the same, regardless of whether

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<sup>28</sup> The exclusion of section 24402 dividends from the interest offset calculation reflects the fact that interest expense relating to the production of exempt dividends is denied separately as a deduction by virtue of Cal. Rev. & Tax. Code, § 24425, which proscribes the deduction of any expense allocable to income not taxable by California. See *Great Western Financial Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 479 P.2d 993 (1971). For this reason, the amount of a corporation's interest expense which is attributable to such non-taxable income, as measured by the section 24402 dividends, is properly not taken into account for purposes of the interest offset statute.

the dividends are paid by a corporation doing business in California. As a result, the overall effect on interstate commerce is roughly equivalent to the tax on intrastate commerce. Corporations that engage in business in California thus are afforded no greater advantage over their foreign counterparts.<sup>29</sup>

Furthermore, even within the context of California's interest offset statute, California's assignment of a foreign

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<sup>29</sup> At worst, section 24402 regulates evenhandedly with only negligible impact on interstate commerce. See *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.*, 511 U.S. 93, 99 (1994). Nondiscriminatory tax statutes which have only incidental effects on commerce are valid unless " 'the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.' " *Id.* No excessive burdens are present here. As noted above, the statute serves the legitimate local purpose of preventing double taxation of the same income by California. Since dividends received from a corporation which is not subject to tax in California is taxed only once, no deduction is necessary with respect to those dividends. As a matter of policy, California's practice of allowing a deduction only where it will alleviate double taxation by a taxing jurisdiction is utterly reasonable.

Furthermore, the legitimate local purpose advanced under section 24402 "cannot be adequately served by reasonable nondiscriminatory alternatives." *Id.* at 101. Without permitting a dividend-received deduction in proportion to the amount of business conducted by the payor corporation in California, the dividend would be subject to taxation twice by California. Conversely, permitting a full 100 percent dividend-received deduction without limitation, as Hunt-Wesson appears to favor, would have the unfair and inadequate result of permitting corporations doing business in California to escape taxation altogether for dividend income which the State is entitled to tax. California has the constitutional right to tax income derived from sources within the State. To permit an unlimited dividend-received deduction would create a tax loophole through which a California corporation could avoid significant State taxation.

corporation's interest expense to nonbusiness income does not necessarily result in the irretrievable loss of a tax deduction. Because California's interest offset statute is internally consistent such that if all states in which a corporation is taxable adopted a statute identical to California's, the corporation's taxable income in the state of domicile would decrease in proportion to the amount that its taxable income in California would increase.

In *Fulton*, the tax liability imposed on North Carolina corporate stockholders was not determined within the context of an allocation of tax burdens among the states. Here there is such an allocation. Under California's interest offset statute, the level of in-state activity does not affect a corporation's overall tax liability, but affects merely the extent to which interest expense is allocated between sources in and out of California. The corporation's overall tax liability from its worldwide income remains unchanged because whatever interest expense is allocated to nonbusiness income is not lost to the corporation: it is simply shifted to the state where the nonbusiness income is subject to tax.

Thus, to the extent that the out-of-state activity of a corporation's nonunitary subsidiary results in an increase in the amount of interest expense assigned to nonbusiness income, a commensurate amount of interest expense becomes available to offset taxable income in the state of its domicile. As a result, the California statute imposes no greater burden on interstate commerce than intrastate commerce. It is this fundamental difference between North Carolina's intangible property tax and California's interest offset statute which renders *Fulton* inapplicable to this case.

In summary, should this Court conclude that a consideration of section 24402, a statute both separate and



severable from California's interest offset statute, is warranted in this case, Hunt-Wesson's claim must fail. California provides no incentive to foreign corporations to invest in companies that engage in business only in the State. Conversely, no penalty accrues from a foreign corporation's election to invest in a subsidiary engaged in activities outside of California. In either case, the overall tax liability to the corporation remains the same, regardless of the level of in-state activity by the dividend-paying subsidiary.

### CONCLUSION

For all of the foregoing reasons, the judgment of the California Court of Appeal should be affirmed.

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### APPENDIX

#### Application of California's Interest Offset Statute to Hunt-Wesson

	1980	1981	1982	TOTAL
Total Interest Expense	80,490,469	55,101,503	137,413,162	273,005,134
Less: Unitary Business Interest Income (A)	10,217,578	21,389,332	83,920,105	115,527,015
Balance (B)	70,272,891	33,712,171	53,493,057	157,478,119
Less: Nonbusiness Dividend Income (C)	26,718,620	29,482,367	19,022,617	75,223,604
Balance (D) (B minus C)	43,554,271	4,229,804	34,470,440	82,254,515
Total Interest Expense Subject to Apportionment in California (A plus D)	53,771,849	25,619,136	118,390,545	197,781,530
Interest Offset (Lesser of B or C)	26,718,620	29,482,367	19,022,617	75,223,604

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